Statement of Allen Sanborn
President and CEO
of
Robert Morris Associates
before the
Subcommittee on Financial Institutions Consumer Credit
U.S. House of Representatives Committee on Banking and Financial Services

Chairwoman Roukema, I would first like to commend you for holding this hearing today. Recent action by the SEC regarding bank loan loss reserves provisioning has caused considerable concern and confusion within the industry. Today, I hope that we can clarify the necessity for banking institutions to provide reserves against risk inherent (expected loss) in the entire loan portfolio. The SEC appears to be changing long-standing bank reserving methodology, and this is what I believe many in the industry find so troubling.

I am Allen Sanborn, President and CEO of Robert Morris Associates, a Philadelphia-based professional association for lending and credit risk officers, representing some 3,000 institutional members and 18,000 individual members throughout North America and offshore in Hong Kong and Singapore. Our primary constituency is comprised of the chief credit officers of banks and other financial institutions. As such, our members are charged with approving counterparty risk within their respective institutions and establishing an appropriate reserve for the losses inherent in the portfolio for both on and off balance sheet facilities.

As a former banker, I am very troubled by what appears to be a change in policy on the part of the SEC with regard to the treatment of bank loan loss reserves provisioning methodology. Prior to joining RMA in 1995, I was Vice Chairman of Shawmut National Corporation in Boston, and preceding 1992, I was at Bank of America in the capacity of Vice Chairman in charge of the commercial markets group. At both banks, I was a member of the Credit Policy, Asset/Liability, and Management Committees, and as a result, have extensive experience in managing loan portfolios and establishing reserves.

As this Subcommittee is well aware, most banks suffered substantial credit losses in the early 1990s as a result of the credit decisions made in the late 1980s as to which loans to underwrite and which to hold in their portfolios. Industry losses during the period from 1990-1992 totaled $50 billion from large commercial and real estate loans alone, an amount equal to 1998's record earnings. Some 1,200 community banks were liquidated and 11 of the top 50 banks were forced into mergers. Yet, most economists characterized the 1990-92 recession as mild from a historical perspective. However, it produced a severe and sustained credit crunch in 1991, 1992, and 1993. Inadequate reserves were a major cause of the extended credit crunch and record high bank failures.

Today the industry is much stronger than it was a decade ago and no one expects losses to rise to past levels. Yet I do have concerns. At present, I believe we are in what I would characterize as the 9th year of a 7-year economic cycle. Federal Reserve Board Chairman Alan Greenspan has said, "All too often at this stage of the business cycle the loans the banks extend later make up a disproportionate share of total non-performing loans."

For the SEC to begin questioning reserves provisioning at banking institutions at this point in the business cycle is, fundamentally, very bad public policy. Banking institutions should be maintaining and in some cases building reserves. Indeed, on November 13 of last year, both the Fed and OCC sent a letter to SEC Chairman Arthur Levitt stating, "We believe that lowering bank loan-loss reserves positions will pose very serious problems given the challenging economic conditions."

While economic conditions have steadied considerably since last fall, the need for banking institutions to maintain strong loan loss reserves has not lessened. In fact, a respected bank analyst, Carol S. Berger, recently expressed concerned about falling loss reserve ratios within the industry. She said, "I'm not a believer of the theory that there aren't economic cycles anymore. The lower the reserve ratios are at the start of the credit cycle, (that is, the end of the expansion), the worse the cycle. It creates the credit crunch. It makes the whole economic environment worse, not just earnings at the banks, but their willingness to lend."

While bank credit losses affect bank earnings and their shareholders, they also have a broader impact on the economy as a whole. Last October, we heard repeated concerns about market liquidity and the prospect of a possible credit crunch. A policy that discourages building loan-loss reserves positions at this time could prove destabilizing to the long-term health of the industry and the economy as a whole.

Without adequate reserves, a banking institution's funding and capital costs will rise and its margin for error will decline, leaving less capital available for lending. As the freeze-up in the capital markets demonstrated last fall, it is imperative that banks continue to make loans when liquidity is stretched. The ability to provide needed credit during difficult economic conditions could be reduced if loan loss reserves are not adequate.

It is for this reason that the SEC's actions have been so disturbing. Public policymakers must understand that reserves serve a far more important purpose for banking institutions than other publicly traded companies. They allow banks to continue lending during bad economic times. When tough times hit, as in 1990-92, they usually produce losses far greater than the loan loss reserves and negatively impact a bank's capital and earnings in a rapid and dramatic fashion, cutting off capital availability to the economy as a whole.

Historically, banks have set a portion of reserves based on a loan-by-loan review of problem assets. The remainder of the reserves provision was based on managerial judgment. It is not possible to review every single loan and measure what event could or could not cause a loss. Today, regression analysis and a number of very sophisticated modeling techniques are employed as tools by banking institutions to measure and control risk and help set reserves. However, management judgment remains a key component of reserves setting. Modeling provides the "science" behind reserves methodology, but management judgment is the "art" of estimating an adequate and conservative reserve.

Since the last recession, banks have made great headway in portfolio risk management and loan loss forecasting. The industry is also more diversified and less vulnerable to geographic concentrations. However, the industry has also expanded lending in areas that may be subject to greater risk during a downturn environment. Throughout this decade the industry has greatly expanded its exposure to individual consumers, with retail lending activities (including credit cards) now comprising 50 percent of some banks balance sheets. Banks have also aggressively expanded into community development lending with the encouragement of Congress and bank regulators. Both these exposures carry heavy risk should the economy falter. Neither have been tested through an economic cycle.

The severe losses of the early 1990s resulted from loans booked during the 1980s. It is precisely for this reason that the banking industry maintains adequate and conservative loan loss reserves. Any loan, once underwritten, is a potential loss. The act of making the loan creates the potential loss. To this end, banks must continue to reserve against the risk inherent in the entire loan portfolio, not simply on a loan-by-loan basis. This includes the necessity to make management allocations based on good and experienced judgment.

This fall, when the SEC initiated its review of bank loan loss reserves provisioning and required SunTrust to make a $100 million adjustment downward, the bank regulatory agencies and many within the industry expressed alarm. Consequently, the SEC signed onto a Joint InterAgency Statement on November 24, 1998 that stated, "loan losses should reflect estimated credit losses for specifically identified loans, as well as estimated probable credit losses inherent in the remainder of the loan portfolio at the balance sheet date."

I found this statement encouraging, as did many in the banking industry. At the time, the capital markets were all but frozen in response to the Russian default. Yet commercial banks continued to lend, supplying much needed liquidity to a very illiquid market. I am very concerned that the ability of the commercial banking sector to provide liquidity in future periods of stress could be impaired if reserves are inadequate.

This concern is heightened by the fact that the SEC, as the capital markets have calmed, appears to have backed away from the November 24 Joint Industry Statement. On March 10, the federal banking agencies and the SEC issued an additional joint statement announcing the formation of a Joint Task Force to develop further guidance on loan loss reserves provisioning. However, this guidance is not expected until March of 2000. On April 12 FASB published a *Viewpoints* article that the SEC adopted as official policy on May 20th.

Many in the banking industry, including myself, expressed concern as FASB moved forward with additional guidance on loan loss reserve provisioning before the Joint Task Force presented its recommendations. Moreover, many believe the *Viewpoints* article failed to clarify a number of concerns surrounding the use of unallocated reserves. On May 17, RMA wrote to both FASB and the SEC to press our strong reservations about adopting the April 12 Viewpoints article as official policy (copies of the letters RMA wrote to FASB and the SEC are attached for your review).

I am very concerned that the regulatory bodies are sending the banking industry conflicting signals. The SEC appears to believe that a number of banking institutions are over reserved and is pursuing policies that have required restatement of earnings and a reduction in the reserve provision. Bank examiners, however, see rising credit risk in the banking system and are pushing institutions to increase reserves.

Recent surveys by both the Fed and OCC indicate that banks have tightened credit underwriting standards due to concerns raised by market events last fall. Clearly, industry practitioners understand that now is the time to prepare for a less favorable economic environment, and they are doing so.

Today the industry is well capitalized and much stronger than it was a decade ago. Indeed, the *Wall Street Journal* carried a recent headline stating, "Hard lessons of '80s left banks tougher." There is little question that advances have been made and that new portfolio risk management tools available to the industry should help lessen the impact of a downturn. However, healthy loan loss reserves remain a critical component to curb risks during difficult economic times. More importantly, reserves can reduce the likelihood of severe credit crunches.

In closing, I would like to stress that financial institutions must set adequate reserves, and doing so effectively requires considerable managerial judgment.

SEC Initiative on Reserves

Reserving is critical to the safety and soundness of the industry, and reserving practices are well established

- In past crisis situations, the risks to the banking system were greatest where robust reserves were lacking.
- In response to past experience, bank regulators have constructed a strong and effective set of rules and guidelines.

Actions have led most observers to conclude that SEC seeks fundamental change in reserving

- SEC staff members are thought to believe excessive reserves are widespread among banks.
- SEC forced SunTrust to reduce reserves, brought intense pressure on others, and sent warning letters to 150 banks.
- In response to broad concern over its actions, SEC agreed with bank regulators that all would work in concert and through established rule-making bodies with full due process to clarify the rules as to reserving.
- FASB, acting after consultation with SEC staff, unilaterally issued guidance in the form of a "Viewpoints" article that goes far beyond existing rules and moves towards minimal reserves, specifically determined.
- While nominally unofficial, the article was immediately anointed as mandatory by SEC staff.
- SEC now states that it is seeking neither fundamental change nor reduced reserves, but it has not withdrawn or modified its endorsement of the "Viewpoints" article.
- Fed wrote a letter to clarify "Viewpoints" article, suggesting that changes in reserves should not be required but also concluding that FASB rules must be followed. Most banks and regulators remain highly concerned.

Both FASB and SEC sidestepped due process requirements in promulating the "Viewpoints" guidance

- FASB did not solicit public comment and kept drafts of the article strictly confidential.
- SEC did not solicit public comment before endorsing the article as mandatory, despite urgings by bank regulators that the matter be opened up for public comment.

"Viewpoints" article and SEC endorsement imply a fundamental change in reserving practices

- Contents of the article are highly controversial among those with the greatest responsibilities related to reserves, including bankers, auditors, and regulators.
- Critics of the article contend that its goes far beyond existing rules to create a framework under which all reserve amounts must be mechanistically determined based on specific identified circumstances.
- Without due process, there is no way that concerns can be aired.

Initiatives for change should be directed towards eradication of abusive practices

- Reserves cannot be used to manipulate or misstate earnings.
- Reserving actions must reflect management's best estimates and expectations.
- Disclosures must be candid and forthcoming as to management's views.

Reserving is inherently judgmental and cannot be made mechanistic

- Other than for consumer loans, reserving is a judgmental process that cannot be reduced to mechanistic calculations.
- Reserving must be forward-looking, whereas mechanistic processes are inherently backward-looking.

The ability of banks to maintain robust reserves should not be constrained

- There should be no requirement that all reserve amounts be associated with specific loans or groups of loans.
- Reserves should not be limited to probable losses that exist at the current stage of the business cycle.
- Banks should reserve with a view to reasonably anticipated changes in business and economic conditions.
- Banks should be able to maintain reserves for unidentified issues that may be on the horizon.
- Reserving decisions reasonably made in good faith should not be challenged based on hindsight.

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May 17, 1999

VIA e-mail

Timothy S. Lucas, Chairman
Emerging Issues Task Force
Financial Accounting Standards Board
P.O. Box 5116
401 Merrit 7
Norwalk, CT 06956-5116

RE: FASB Viewpoint No 196-B / April 12, 1999

Dear Mr. Lucas:

I am writing on behalf of Robert Morris Associates (RMA), the association of lending and credit risk professionals, to comment upon FASB Viewpoints article No. 196-B, published on April 12, 1999.

RMA's primary constituency is comprised of the chief credit officers of banks and other financial institutions. As such, our members are charged with approving counterparty risk within their respective institutions and establishing an appropriate reserve for the losses inherent in the portfolio for both on and off balance sheet facilities. One of the largest concentrations of counterpary risks that banks face are with other financial institutions, including banks. Thus, creditor banks take into consideration the level of reserves an institution holds when providing credit facilities supporting lines of credit, foreign exchange activities, and other facilities for financial institutions.

In reviewing the April 12 FASB Viewpoints article, our constituency is concerned that there is not a direct discussion of managerial judgement. Setting reserves requires managerial judgement on a loan-by-loan basis for problem assets and modeling and other methodologies for non-criticized loan categories. In addition, judgement should be used to establish additional reserves for events that have occurred, but have yet to produce results that can be captured in the models or in the loan-by-loan analysis. Judgement is also particularly important when making large loan decisions and in managing portfolios. Historically, management has relied upon judgement (sometimes called unallocated reserves) to account for events that have occurred as of the statement date but have not at that point been captured in the loan-by-loan or model processes.

For example, as of 12/31/98, two events had occurred which required managerial judgement to be appropriately reserved on a portfolio basis:

- Oil prices were less than $10 a barrel. Clearly, this event was having additional negative impact on borrowers and portfolios on the statement date.
- Agricultural prices for corn, soybeans and wheat were at 30-year lows and hogs were selling at 10 cents, 25 cents below the most efficient cost of production. Again, institutions with exposure to this industry should establish an unallocated or judgement reserve for the additional risks in the portfolio.

RMA's members believe that the April 12 Viewpoints article should not become guidance without further public comment and revision. Indeed the article carried a disclaimer stating, "The views expressed in this paper are those of the authors. Official positions of the Financial Accounting Standards Board are determined only after extensive due process and deliberation."

From what we know to date, "extensive due process and deliberation" has not taken place with regard to the April 12 Viewpoints article. At the very least, if FASB is going to adopt the article, it should be expanded to include a section on the importance of using good managerial judgement to ensure that an institution's portfolio is properly reserved at statement date.

Finally, RMA believes that it is important to look back at what happened during the last economic downturn (one that most economists said was mild). Eleven of the top fifty U.S. banks in 1989 were forced into mergers because they were inadequately reserved. Some 1,200 community banks, about 10% of all banks, were forced into liquidation because of inadequate reserves. Clearly, shareholders and creditors were each adversely affected, as reserve levels were inadequate. Given that the economy will be tested, we want to be sure that actions taken today do not encourage lenders to under reserve, which could in turn cause significant losses to shareholders and creditors alike.

Tim, I would be pleased to discuss my concerns with you further and can be reached at (215) 446-4001. Thank you for your consideration.

Sincerely,

Allen Sanborn
President and CEO

cc: A. T. Cope, FASB
Lynn E. Turner, Chief Accountant, SEC

Back to Loan Loss Reserves

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May 17, 1999

Via Fax

Mr. Lynn E. Turner
Chief Account
U. S. Securities and Exchange Commission
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RE: FASB Viewpoint No. 196-B / April 12, 1999

Dear Mr. Turner:

Enclosed please find RMA's letter to Mr. Timothy Lucas containing our comments upon FASB Viewpoints article No. 196-B. As you know from our previous correspondence to Chairman Levitt, RMA is very concerned about the adoption of public policy directives that could encourage banking institutions to under reserve.

We are particularly concerned that the Viewpoints article does not contain a direct discussion of managerial judgement. In fact, since managerial judgement is not specifically acknowledged in the article, it could be assumed that it is discouraged, or worse yet, not allowed. Moreover, the article has not been widely reviewed and has certainly not been subject to a public review and comment period.

I also understand that there is some disagreement within the banking industry regarding the impact of the article itself. For these reasons, RMA believes that the Viewpoints article should not become part of generally accepted accounting principles at this time. At the very least, a transition period beyond the planned first fiscal quarter ending after May 20, 1999 should be granted.

In your November 25, 1998, letter to me you state that, "the agencies will work together and with the public accounting profession and banking industry to develop further guidance, consistent with generally accepted accounting principles, that will ensure transparency of the reported amounts, improve auditability, and serve as a benchmark for the exercise of prudent judgement in setting these reserves." I would respectfully submit that the April 12 Viewpoints article does not address the latter objective of establishing a benchmark for the exercise of prudent judgement.

Again, RMA believes that it is very important to provide further discussion and guidance on the role of judgement in setting reserves. We stand ready to work with you to move such an initiative forward.

Sincerely,

Allen Sanborn
President and CEO

Encl.

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